New Del. Bankruptcy Judge Issues 1st Opinion, Insurer Favored

By James E. Huggett
Special to the DLW

Newly appointed Delaware Bankruptcy Court Judge Kevin Gross issued his first published opinion this fall.

He granted a motion filed by Pacific Employers Insurance Co. to compel arbitration of a dispute with the trustee of bankrupt insured Olympus Healthcare Group. Gross is being closely watched by the legal community as one of four new Delaware bankruptcy judges (three of whom came from private practice, including Gross).

The court is the locus of many large corporate bankruptcies, most of which usually involve major insurers. Thousands of insureds file for bankruptcy each year around the country, and many of their policies provide for arbitration of any disputes between insured and insurer.

Gross clarifies under what circumstances the Delaware Bankruptcy Court (and others that follow it) will enforce contractual arbitration provisions. Additionally, the opinion represents one of the first local applications of the 3rd Circuit's recent decision in *Mintze v. American General Financial Services Inc.*, and a split with the legal standard set forth in *Winstar*, a decision by a different Delaware bankruptcy judge on the same issue. If your company or clients care about arbitration provisions, read on.

MINTZE DECISION

In *Mintze*, then-Philadelphia bankruptcy Judge Kevin Carey (himself also one of the four newly appointed Delaware bankruptcy court judges) voided an arbitration clause at the request of the debtor-insured, and the district court upheld. The 3rd Circuit reversed. It held that the Federal Arbitration Act (FAA) creates a strong presumption favoring enforcement of such clauses, even where one party goes bankrupt and tries to escape them.

However, *Mintze* did allow parties to avoid arbitration by showing that Congress intended to preclude them from waiving their judicial (that is, non-arbitration) remedies for the statutory rights at issue in the suit. This holding relied on language from the Supreme Court's 1987 *McMahon* opinion. In *Olympus* such a showing would allow the trustee to void an otherwise proper and enforceable insurance arbitration clause (providing for confidential arbitration in Philadelphia) and proceed with a nonjury trial against Pacific in Delaware Bankruptcy Court.

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OLYMPUS/PACIFIC DISPUTE

With 1,600 employees in nine facilities, Olympus provided acute, chronic, medical and rehab health care services to more than 900 patients in two northeastern states. Pacific and Olympus had a workers' compensation program with a "funded deductible" to be governed by Pennsylvania law. Pacific agreed to cover Olympus on workers' compensation claims, but in turn Olympus had to fund, usually in advance, many categories of expenses and reimbursements it expected to incur. Olympus sent the money to Pacific to be held in a special account, with periodic auditing and "true-up" provisions to ensure that Pacific returned to Olympus any overpayments and Olympus would make up for any shortfalls.

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Olympus filed for bankruptcy in Delaware in 2001 and confirmed a plan of liquidation in 2002. The plan appointed the trustee to wind down operations and pursue the debtor's causes of action against Pacific, among others.

The Trustee sued Pacific in the Delaware Bankruptcy Court. He claimed Pacific owed Olympus at least $175,000 and refused to pay. The trustee sought these monies plus interest and damages for alleged breach of contract at state law. And since Pacific held the monies even after Olympus filed Chapter 11, he also sought damages for violation of the Bankruptcy Code's automatic stay provision and failure to "turn over" Olympus' property to its bankruptcy estate. Pacific denied all claims, but asked Gross to compel enforcement of its arbitration clause.

ANALYSIS

In granting Pacific's motion, Gross considered whether the Pacific/Olympus arbitration clause was enforceable and covered this dispute; whether he had any discretion to deny enforcement of the clause, and if so; whether exercising same was appropriate.

Finding for Pacific on the first issue, he rejected the Trustee's arguments that the clause was unenforceable because it was "procedurally" or "substantively" unconscionable. There was no evidence that the procedure whereby Olympus entered this contract was improper, both parties being sophisticated and the clause being prominently labeled in the document.

The Trustee argued that the clause was "substantively" unconscionable because it did not require the arbitrators to strictly follow "rules of law", but instead allowed them to consider the "custom and usage[s]" in the insurance business in reaching a decision.

These provisions, according to the Trustee, conflict with the Bankruptcy Code objective of equity and would unfairly slant the arbitrators in favor of insurers like Pacific. Gross rejected these claims, finding that arbitration tribunals are competent and have access to a substantial set of rules and procedures designed to ensure fairness (e.g., the right to offer evidence, to challenge evidence of your adversary, etc.). Indeed, the clause in question provided for use of the AAA's commercial arbitration rules.

WINSTAR IS 'CLARIFIED'

The clause being enforceable and applicable, Gross followed the FAA presumption in favor of arbitration, and then asked whether he nevertheless had discretion to deny enforcement here. The first task was to categorize the claims in the suit.

Before *Mintze*, a different Delaware Bankruptcy Court judge in *Winstar* denied enforcement of an arbitration clause because it categorized the claims in that suit as "core" bankruptcy matters, as opposed to "noncore." In the 3rd Circuit,

Arbitration *continues on page 4*

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Arbitration

Continued from page 3

core matters are essentially legal rights that arise upon commencement of a bankruptcy case and would not exist but for bankruptcy (e.g., "preference" suits), and are therefore integral to the bankruptcy process. Most other matters are noncore. The *Winstar* court found that bankruptcy courts (not arbitrators) should decide "core" matters, notwithstanding previous arbitration agreements.

Gross found that *Mintze* "clarified" *Winstar*. He found that the proper analysis after *Mintze* is not "core" versus "noncore" but instead "derivative" versus "nonderivative."

If the claims at issue derived from the bankrupt debtor (that is, the debtor would or could have possessed the claims prior to bankruptcy or without resort to the provisions of the Bankruptcy Code), the court lacks any discretion to deny arbitration. However, if the claims were created by the Bankruptcy Code for the benefit of creditors, and thus are "nonderivative" of the debtor, such discretion will exist.

The rationale is simple: *Olympus* agreed to the arbitration clause, so any party (e.g., its bankruptcy trustee) bringing claims derived from *Olympus* should be bound thereby; however creditors of Olympus made no such bargain and should not be so bound. Gross found that the trustee's claims for turnover, automatic stay violations and state-law breach of contract were all derivative of *Olympus*, and thus ruled that he had no discretion to deny arbitration.

Finally, reviewing *Mintze*, Gross questioned whether the could show Congress intended to preclude companies like Olympus from waiving their judicial remedies for the claims at issue. The Trustee argued that arbitration would interfere with bankruptcy objectives like equality of distribution and efficient claims resolution. He claimed that allowing some parties to arbitrate disputes with bankrupt companies would "exalt" them over other parties that lacked arbitration rights, and that arbitrations would delay distributions to creditors in bankruptcy.

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He also argued that bankruptcy judges were better suited to decide disputes of this type than arbitrators without bankruptcy specialization. Gross found no evidence in the Bankruptcy Code or its legislative history for these positions, and rejected them.

CONCLUSION/APPLICATIONS

This is a victory for insurers (and others), many of which draft, bargain for and rely upon arbitration clauses to resolve coverage and other disputes with their insureds. Gross' decision is helpful to the insurance community; there is a fair argument that insurers should not be deprived of the benefit of their bargain struck with an insured simply because of bankruptcy vagaries (e.g., an insured company files and then is taken over by a trustee who wants to succeed to all company rights but avoid its obligations).

The FAA policy favoring arbitration has been upheld despite alleged conflicts with generalized bankruptcy policies. While insolvency and bankruptcy alter the landscape in many legal areas and inject the interests of a third party (the creditor body) into two-party contracts, here there was no compelling evidence to prove that creditors would be harmed if the court simply enforced Pacific's contractual rights. This helps insurers know the "lay of the land" when a difficult or litigious insured goes bankrupt.

There are potential problems with the analysis. Again, *Mintze* seeks to reinforce the distinction between debtor-derivative claims (no discretion to deny arbitration) and claims created by the Bankruptcy Code for the benefit of creditors (discretion exists). It is perhaps tricky to distinguish between the two categories.

Here the state-law breach of contract claim is clearly derivative of *Olympus* — such claims exist pre-bankruptcy and are not created by the Bankruptcy Code. But bankruptcy practitioners will quickly note that a claim for damages resulting from an automatic stay violation is by definition a claim created by the Bankruptcy Code, as is the automatic stay itself, and so are "turnover" actions. They do not exist outside of or prior to bankruptcy, and thus are arguably nonderivative of the bankrupt debtor, yet Gross found them to be derivative.

For now, the lesson for insurers and others that rely on arbitration clauses is this: if one party to the clause files for bankruptcy, the enforceability of the clause turns on the nature of the claims asserted in the lawsuit. For each claim, you need to consider whether it was created by the Bankruptcy Code for the benefit of the debtor's creditors (nonderivative) or would exist irrespective of bankruptcy (nonderivative). If it is the former, your clause should stand; if the latter your clause and arbitration rights may be in serious jeopardy. •

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